

**Mortgage Financing Beyond the GSEs**

**Stuart A. Gabriel**  
**UCLA**

**Conference on Bank Structure and Competition**  
**Federal Reserve Bank of Chicago**  
**May, 2012**

## **The Setting**

**With the collapse of private securitization, virtually all residential mortgage securitization is now in the hands of the U.S. Government**

**The housing GSEs, once the envy of the world, remain in government conservatorship and in political limbo, having cost the taxpayer almost \$200B to date**

**Question of the day: should the U.S. remain in the mortgage insurance business, and if so, on what terms?**

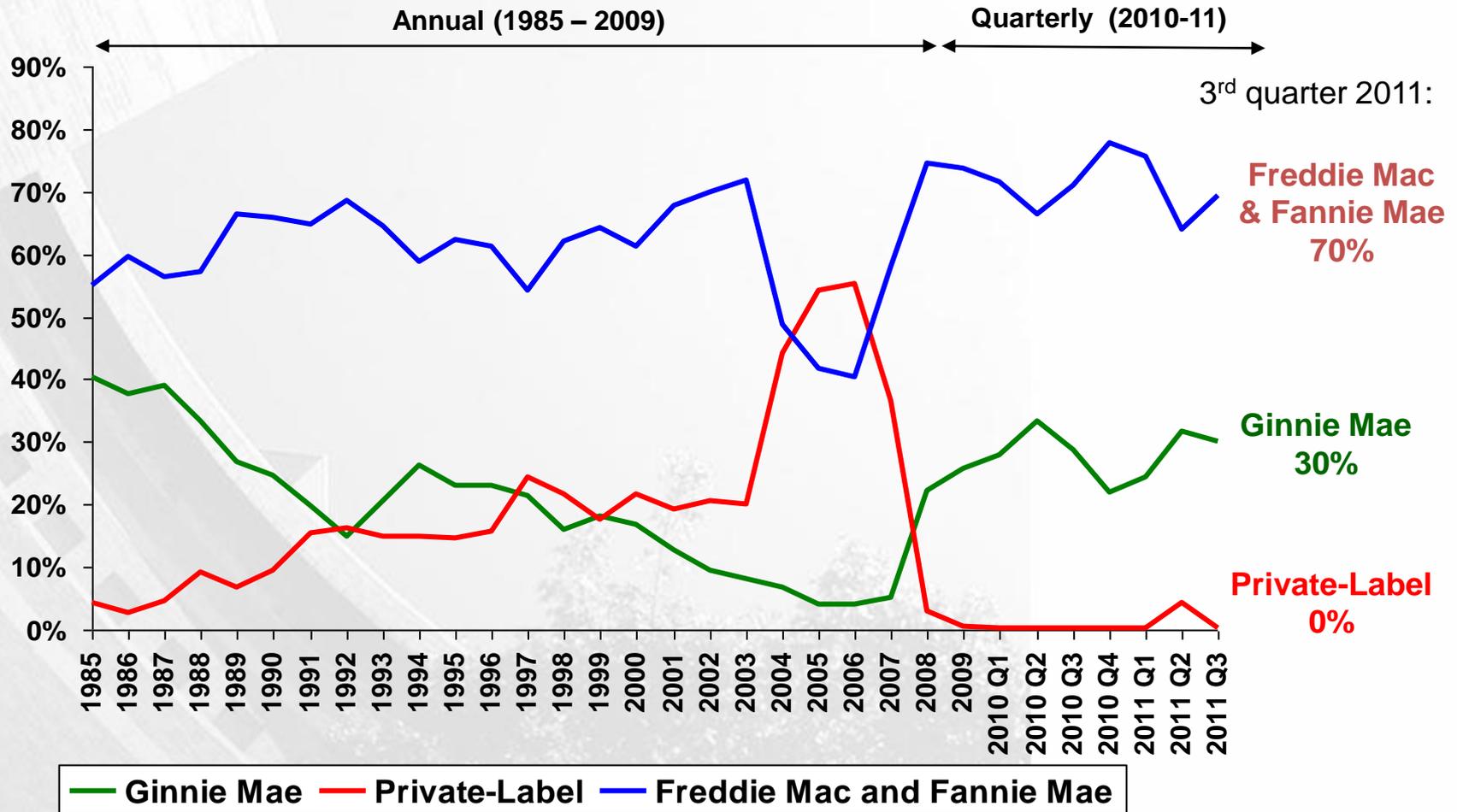
## **Indictment of the GSEs**

- **Only about half the 30-40 basis point GSE funding advantage was passed to consumers in lower rates**
- **GSE affordable housing loan purchase programs were of limited efficacy in achievement of homeownership**
- **The GSEs had a destabilizing influence on mortgage markets and served to exacerbate the subprime boom**
- **The GSEs contributed little to MBS innovation**
- **During the boom years, the GSEs crowded out private mortgage purchase activity**

## **But as boom turned to bust....**

- **Private mortgage origination and securitization fell away**
- **GSE crowd out disappeared**
- **Federally-backed loans achieved a 95% market share**
- **GSE securitization with explicit U.S. guarantee remained robust at about \$300B per quarter**
- **GSEs in government conservatorship became an important instrument of macroeconomic and housing stabilization policy**

## MBS Share Issuance (Percent of MBS Issuance)



Sources: Inside MBS & ABS (The 2011 Mortgage Market Statistical Annual - Volume II),  
Office of the Chief Economist (June 3, 2011 and October 21, 2011 issues)

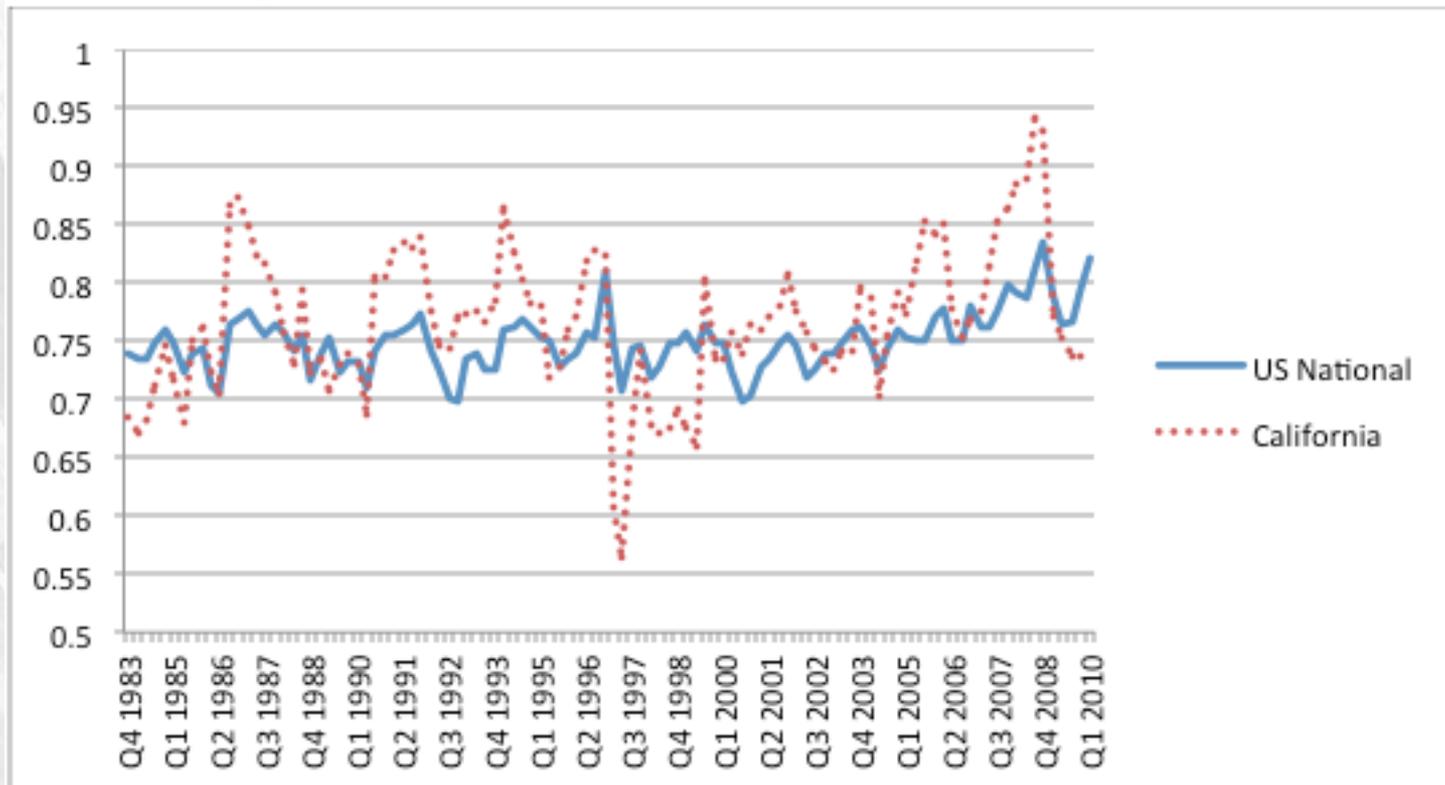
Note: Private-Label MBS excludes scratch & dent loans and re-MBS (1995-2011)

# **Housing Market Integration and the Collapse of Residential Securitization**

- **As the housing downturn deepened, geographic diversification of MBS holdings by investors and insurers yielded few benefits**
- **Even seemingly well-diversified MBS investors experienced substantial losses, owing in part to high levels of systemic risk in US housing markets**
- **Private security issuers, investors, and insurers did not understand the high levels of geographic and temporal integration, correlation, and contagion pervasive in US metro housing markets**

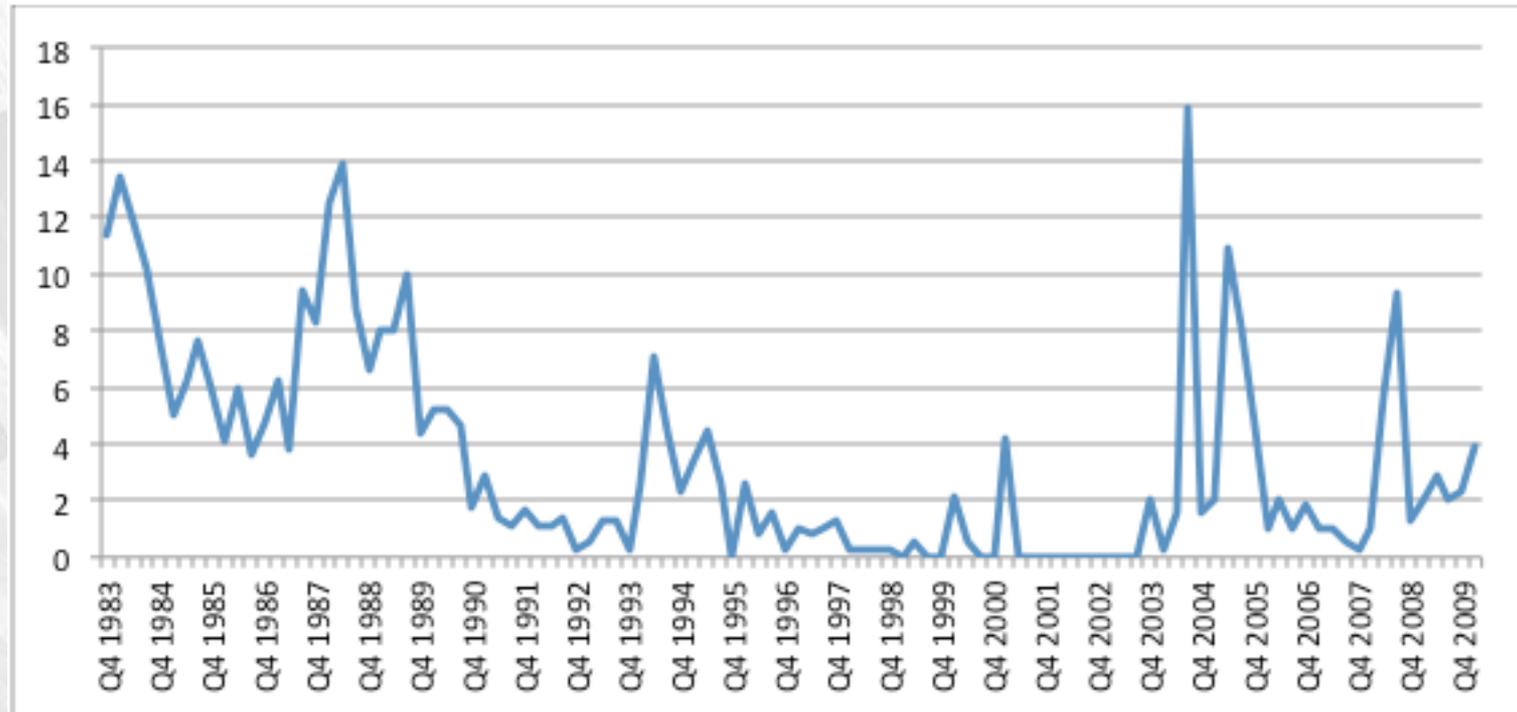
## Housing Return Integration Trends

Average R-squares for US MSAs and California MSAs



## Incidence of Extreme Movements in US House Price Returns

Percent Lee and Mykland House Price Return Jumps for US MSAs by Quarter



# Metropolitan House Price Contagion

Los Angeles

	<b>N</b>	<b>Constant</b>	<b>Lag0</b>	<b>Lag1</b>	<b>Lag2</b>	<b>Lag3</b>	<b>R-Squares</b>
<b>Bakersfield</b>	<b>130</b>	<b>-0.460</b>	<b>0.600</b>	<b>0.350</b>	<b>-0.210</b>	<b>0.120</b>	<b>0.516</b>
		(-2.010)	(4.360)	(2.050)	(-1.220)	(0.880)	
<b>Fresno</b>	<b>131</b>	<b>-0.280</b>	<b>0.600</b>	<b>0.290</b>	<b>-0.230</b>	<b>0.190</b>	<b>0.509</b>
		(-1.200)	(4.320)	(1.730)	(-1.340)	(1.400)	
<b>Oxnard</b>	<b>135</b>	<b>0.100</b>	<b>1.070</b>	<b>0.070</b>	<b>-0.120</b>	<b>-0.090</b>	<b>0.867</b>
		(0.850)	(16.420)	(0.890)	(-1.430)	(-1.300)	
<b>Riverside</b>	<b>135</b>	<b>-0.540</b>	<b>0.950</b>	<b>0.110</b>	<b>0.100</b>	<b>-0.060</b>	<b>0.788</b>
		(-3.300)	(10.100)	(0.970)	(0.810)	(-0.640)	
<b>San Diego</b>	<b>136</b>	<b>0.190</b>	<b>0.900</b>	<b>-0.190</b>	<b>0.030</b>	<b>0.060</b>	<b>0.564</b>
		(0.940)	(7.610)	(-1.270)	(0.200)	(0.510)	
<b>Santa Ana</b>	<b>136</b>	<b>0.100</b>	<b>0.900</b>	<b>0.020</b>	<b>0.010</b>	<b>-0.010</b>	<b>0.895</b>
		(1.040)	(17.170)	(0.250)	(0.140)	(-0.270)	
<b>Santa Barbara</b>	<b>129</b>	<b>0.220</b>	<b>0.890</b>	<b>-0.080</b>	<b>0.070</b>	<b>-0.050</b>	<b>0.649</b>
		(1.240)	(8.390)	(-0.590)	(0.550)	(-0.450)	

# Government-Backed Credit Guarantor

- In a severe downturn, a private insurer of mortgage risks may not be viable, given geographically and temporally correlated credit losses, the substantial magnitude of required guarantees, and constrained access to capital markets
- Here an explicit government guarantee may be necessary to resolve problems of systemic risk, facilitate issuance and hedging of long-term debt, enhance financial stability, and provide the FRB with more options to deal with a liquidity crisis
- If the guarantee is credible, MBS can be traded among investors in all market conditions—whether times are good or bad

# **Government-Backed Credit Guarantor**

## **The Guaranteed Product**

- super safe, homogenous, plain vanilla mortgage**
- government's role would be narrowed to deeply subordinated loss position and would come into play only in severe housing downturn**
- low required LTVs on government-backed mortgages imply that borrowers, lenders, PMI, and the like take first loss position**

## **Actuarially Fair Pricing of Explicit Credit Guarantee**

- Risk-based pricing of insurance premia would be based on loss expectations associated with severe downturn**

## **Portfolio Holdings**

- Treasury White Paper calls for sharp cut-backs in portfolio holdings**
- Absent affordable housing goals, little need for portfolio holdings of private non-prime MBS**

# **Moving forward....**

## **Goals of Federal Government in Support of Housing**

- facilitate liquidity, financial stability, and funding of mortgages at reasonable costs in good and bad times**
- assure adequacy of homeownership and rental options (re-balance tenure bias)**

## **Underserved Populations/Affordable Housing Goals**

- eliminate harmful conflation of social and private missions of mortgage insurer**
- transfer residual homeownership goals to FHA, VA**

## **Timeframe of Transition from GSE Model**

- liquidity provision by the GSEs remains vital to current fragile housing market**

**For a detailed analysis of integration, correlation and contagion in US housing markets, see:**

**Cotter, John, Stuart A. Gabriel, and Richard Roll, “Integration and Contagion in US Housing Markets” Finance Working Paper 9-11, UCLA Anderson School of Management**